Financial Stability Institute

BANK FOR INTERNATIONAL SETTLEMENTS

Insolvency options for smaller banks

DIA and IADI International Conference

Deposit Insurance and Bank Liquidation: Standards, Best Practices and Innovations

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Outline

- Effective insolvency options for smaller banks
  - FSI Insight papers on managing failures of non-systemic banks and use of DI funds for purposes other than pay-out
  - Terminology: 'insolvency' and 'resolution'
  - Elements of effective bank insolvency regimes
  - Instruments or actions in bank insolvency
  - Use of DI funds to prevent or support insolvency
  - Reflections

FSI Insights No 10: How to manage failures of non-systemic banks? A review of country practices

- Banks are special (leverage and maturity mismatches; essential services providers; transmission channel for monetary policy, etc), and banking crises are costly
  - Failure of even smaller banks can give rise to systemic concerns
- Yet about a third of countries worldwide have no bank-specific insolvency regime (World Bank (2012))
- Implementation of Key Attributes (international standards for resolution) limited in many jurisdictions to systemic banks
  - Outstanding question: what insolvency procedures and tools work for smaller and deposit-funded banks?
- FSI Insight paper, October 2018:
  - highlights different approaches of bank-specific insolvency regimes of 12 selected jurisdictions
  - discusses elements that may be effective for bank insolvency

https://www.bis.org/fsi/publ/insights10.pdf


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FSI Insights
on policy implementation
No 10

How to manage failures of non-systemic banks? A review of country practices

By Patrizia Baudino, Antonella Gagliano, Edoardo Rulli and Ruth Walters

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Terminology: Insolvency and Resolution

- No commonly agreed definitions
- Different approaches: single framework for (administrative) bank insolvency vs separate resolution and insolvency regimes
  - FSB Key Attributes – bank resolution includes liquidation
  - In some jurisdiction, bank insolvency regimes include 'resolution' (eg, transfer) powers
  - Elsewhere (eg, EU) resolution and insolvency are distinct
- For purposes of the FSI paper, define by guiding objective
  - Resolution for systemic banks: preserve critical functions of failing bank, to avoid a major disruption to the financial system (systemic or public interest dimension)
  - Insolvency for non-systemic banks: wind-up the bank in an orderly way, maximising returns for creditors
    - But may include depositor protection objective

Common features of bank insolvency regimes

- Additional objectives beyond standard insolvency objective of maximising creditor value
  - In particular, depositor protection (even where judicial)
  - In some cases, financial stability
- Broader range of grounds for opening insolvency compared to ordinary corporate regimes
  - Eg, capital triggers or material regulatory breaches
- Role of administrative and judicial authorities:
  - Expanded role for administrative authorities
    - This is particularly the case where the responsible authority is the deposit insurer
- Role of creditors: Reduced procedural role for creditors

Regimes and proceedings

Insolvency regimes and proceedings

Type of regime and administrative vs court-based proceedings

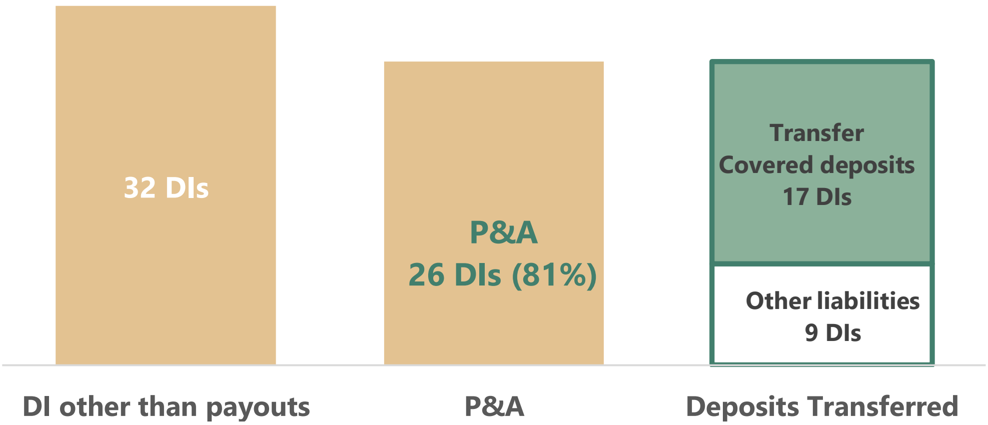
Jurisdiction	Type of regime	Administrative vs court-based proceedings
Brazil	Free-standing bank insolvency regime	Administrative*
Canada	Free-standing bank insolvency regime**	Court-based
Greece	Free-standing bank insolvency regime	Administrative
Ireland	Modified corporate insolvency law	Court-based
Italy	Free-standing bank insolvency regime	Administrative
Luxembourg	Free-standing bank insolvency regime	Court-based
Mexico	Free-standing bank insolvency regime	Administrative***
Philippines	Free-standing bank insolvency regime	Administrative***
Slovenia	Free-standing bank insolvency regime	Administrative*
Switzerland	Free-standing bank insolvency regime	Administrative
United Kingdom	Modified corporate insolvency law	Court-based
United States	Free-standing bank insolvency regime	Administrative

Instruments or actions available in bank insolvency

- Range of instruments varies
  - Insured deposit pay-off and liquidation
  - Transfer (eg, P&A): alternative to pay-out, preserves access
  - In some cases, bridge banks (used to preserve value and access to deposits, pending sale)
- In sample, widest range of tools in administrative regimes where the responsible authority is also the deposit insurer
- Options may be expanded where funds are available (eg, ability to use deposit insurance funds for wider purposes)
  - Loss-sharing agreements or guarantees

Use of DI funds for purposes other than pay-out

- 2/3 of sample of over 50 IADI members can use DI funds for ‘alternative’ measures
  - 80% can fund a P&A,
    - Of those, approx. 70% can only fund transfer of covered deposits (no other liabilities)



  - 60% can provide financial support (eg, capital and/or liquidity) to banks (or bridge bank) in resolution or insolvency
  - 40% can provide financial support to prevent failure

Safeguards

- **Cap on the amount of DI funds that may be used**:
  - Financial cap or least cost test applies in 80% of cases
  - Of which 40% - Exemptions or override available in specified circumstances (generally risk to financial stability or economy)
    - Capital support – cap 90%; override > 50%
    - Liquidity – cap 85%: override 40%
- **Control in decision-making**
  - 60% of DIs are solely responsible for decisions about use of funds
    - 40% DIs are also resolution authority
  - 20% - joint decision with other authority (of which DI veto - 70%)
- **Back-up (emergency) funding**
  - Public only – 10%
  - Private only – 25%
  - Public and private – 60%
  - None – < 5%

Reflections: Effective insolvency regimes for banks

- Specifically-designed insolvency regimes can deal with banks that do not meet public interest thresholds for resolution.
- Bank-specific insolvency regimes may be tailored to better address the specific characteristics of banking business, the need for timeliness and specialised expertise.
- Trade-offs between administrative and court-based regimes in terms of speed, efficiency, specialist expertise and safeguards for creditors.
- A wider range of instruments could make insolvency regimes more effective and better preserve value.
- Readiness planning is relevant for all bank insolvencies, eg for rapid transfer or pay-out of deposits.
- Cross-border dimension of any insolvency or resolution is complicated and challenging
  - Bank-specific regimes alone do not address this, but coordination may be easier between administrative authorities than courts

Reflections: Use of DI Funds

- **P&A transactions** can protect depositors, reduce costs to DIF, preserve value and reduce disruption.
  - Arrangements such as loss-sharing can reduce up-front payment but require skilled staff to monitor and assess acquirer's ongoing valuation
- **Financial assistance –** expand options but entail risks:
  - 'double jeopardy', moral hazard, assessing solvency, collateral management and valuation, relationship with central bank liquidity …
- **Financial cap -** Minimises risks of fund depletion, but may limit options in broader stress conditions (eg, if no resolution fund):
  - Cap may be more or less restrictive depending on the costs included (eg, less restrictive if indirect or contagion costs are included)
  - Impact of depositor preference: eg, super-priority for covered deposits → high recoveries for DI in insolvency may materially restrict amount of DI funds that can be used for alternative measures.
  - Systemic exemption or over-ride offers more flexibility but requires adequate back up funding arrangements for DIF

THANK YOU

Благодарю!